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BEFORE THE

SURFACE TRANSPORTATION BOARD

STB EX PARTE NO. 582 (Sub-No. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

REPLY OF FARMRAIL SYSTEM, INC.

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REPLY OF FARMRAIL SYSTEM, INC.

Farmrail System, Inc. ("FMRS")[1] files this Reply to the Comments filed by various parties in this proceeding in response to the Advance Notice of Proposed Rulemaking ("ANPR") served by the Board on March 31, 2000.

General Reply

In reading the submissions of the other commenting parties, FMRS is struck by the difference between the principal Class I carriers' remarks about the theory of competition and rail users describing competition in practice. The views of those intent on maintaining the *status quo* – Eastern and Western duopolies that are short of capacity and unable to deliver consistent service to the full spectrum of current and potential customers – are distinct from the views of others seeking to promote competition as a means of improving performance for shippers. Shippers as a group clearly are unhappy.

[1] As noted in its initial Comments, FMRS is the parent of two Class III railroads, Farmrail Corporation and Grainbelt Corporation, both of which operate in western Oklahoma.

A skeptic might say that the "urge to merge" has served as a convenient distraction from the commercial reality that no mega-railroad of any size has conclusively demonstrated an ability to run by the clock and meet contemporary service demands, particularly with respect to general-merchandise traffic. Ironically, the most promising freight innovation under deregulation is the scheduled less-than-carload business of Amtrak, traffic which the Class I carriers drove away years ago and then strongly resisted when Amtrak elected to offer it.

The Board's emphasis in merger proceedings now should be on enhancing competition and promoting industry growth for the benefit of all participants. Protests by Class Is about capacity constraints ring hollowly after 20 years of management preoccupation with down-sizing and cost-cutting. There is latent demand for rail service that cannot be accommodated by an industry still burdened by the arrogance of a distant past when competition was lacking and the defensiveness of a recent past characterized by unacceptable service deficiencies. As Class I carriers continue to merge, FMRS sees a return to the past where competition is reduced and market dominance heightened. A "my-way-or-the-highway" mind set is driving available business to the highway, especially in carload-traffic territories served by small railroads.

The lack of meaningful recognition of small-railroad issues by the Class Is, with the notable exception of Kansas City Southern Railway Company ("KCS"), is telling. It reflects a dismissive attitude toward connecting light-density carriers reaching into the nation's nooks and crannies. The largest Class Is apparently would prefer to deal with short lines one-on-one rather than as a legitimate class. Only through the American Short Line and Regional Railroad Association ("ASLRRA"), or changed procedures adopted by the Board, do the 500-odd small railroads have any hope of leveling the playing field in an industry where the size disparity between the "Big Four" and "Little 500" has become so overwhelming.[2] The comments previously submitted by FMRS, other small railroads, numerous shippers, and public agencies demonstrate the need for adoption in future mergers of ASLRRA's "Bill of Rights" or similar conditions.

As observed by one short line, "...corporations do not merge for reasons that are in the public interest. Corporations merge because they perceive a private business advantage...." *Keokuk Junction Railway Co. Comments*, at 6.[3] The reality is that "strategic alliances" among public companies are designed to increase economic power, and Wall Street historically has rewarded market dominance. It certainly is in the public interest to have a capital-adequate railroad industry, but not so if market dominance results in conduct adversely affecting a significant portion of the shipping public, other railroads, and entire communities.

If the public interest is to be determined by pure economics, then we can anticipate a national rail network of perhaps 100,000 miles of inter-city corridors handling long-distance unit trains and fed by short-haul trucks at a limited number of transloading points. As the ill-fated Chicago, Rock Island & Pacific Railroad Company discovered, however, when the twigs and branches of the tree are systematically lopped away, the trunk begins to wither as well. It is hard to imagine that a further down-sized core rail network interfacing with a myriad of local truckers can be as seamless or as valuable to many customers as a truly integrated system of "wholesale" trunk railroads and "retail" short lines. Moreover, industrial development sites

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[2] Even KCS, a smaller Class I, complains of the disparity. *KCS Comments*, at 64-66.

[3] References to "___________ *Comments*" refer to the initial comments filed in this proceeding by the designated party.

along core routes are becoming less and less desirable for shippers because of the low priority given to local switching on heavily traveled main lines.

Although the Class Is claim the problems faced by shippers and short lines are industry issues and not merger-related, they ignore changes in their policies that have followed the mergers of recent years. Those changes may benefit the Class Is, but they adversely affect the public. The public interest is not served by placing the demands of large-volume shippers far above those generating carload traffic.[4] It is not served by intentionally drying up traffic on branch lines and shifting it to vulnerable secondary highways and rural roads.[5] It is not served by disadvantaging the rail-using industry in small towns in outlying areas where the economy is fragile.[6] It is not served by mindlessly emphasizing length of haul to the exclusion of shorter-distance, truck-competitive movements.[7] It is not served by inducing captive customers to invest in rail facilities and then handling their business only when and to where the railroad chooses.[8] It is not served by operating and pricing policies that devalue public-sector investments made to support light-density infrastructure.[9] Neither is it served by discriminatory treatment of short

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[4] *See Wisconsin Central Ltd. et al. Comments*, at 4; and *Wyandot Dolomite, Inc. Comments*, at 2.

[5] *See North Dakota Public Service Commission et al. Comments*, at 5 and 7; and *U.S. Department of Agriculture Comments*, at 8.

[6] *See North Dakota Public Service Commission et al. Comments*, at 5.

[7] *See Kansas Department of Transportation et al. Comments*, at 9; *Montana Rail Link, Inc. et al. Comments*, at 4; and *Wisconsin Central Ltd. et al. Comments*, at 9.

[8] *See McKinley Paper Company Comments;* and *AG Processing Comments*, at 2-4.

[9] *See Chillicothe-Brunswick Rail Authority et al. Comments*, at 1; and *Oklahoma Department of Transportation Comments*, at 5.

lines with respect to service and ratemaking.[10]

Most significantly, the public interest is not served by a transcontinental duopoly, and the existing split duopoly leaves much to be desired from the standpoint of real competition. As noted by the Committee to Improve American Coal Transportation ("IMPACT"), "Competition requires competitors ...," and "two railroads with a continent-wide rail duopoly are likely to compete even less vigorously than they do with a duopoly in a particular market." *IMPACT Comments*, at 8-9. "Canadian shippers are well aware of the difficulties caused by a transcontinental rail duopoly." *Canadian Resource Shippers Corporation Comments*, at 3. *See also U.S. Department of Agriculture Comments*, at 14. "Past merger policies have not considered it against the public interest to allow railroad carriers to become completely dominant in large geographic areas," and "...rail customers in this country are already faced with the negative by-products of a two-monopoly and in many cases, a single monopoly rail system." *Montana Wheat & Barley Committee et al. Comments*, at 2.

Analogous merger issues now are being raised in the airline industry by the proposed combination of UAL Corp. and US Airways Group, Inc. According to a press report announcing the transaction, "Travel analysts said passengers can expect higher prices if the deal goes through because there will be less competition. And while the huge combined airline could make it easier to book flights around the world, it also could make it easier for labor trouble to cripple air travel. 'It's going to mean higher prices, and if it doesn't, it's going to be the first time in the history of the free enterprise system,'" said one airline-industry observer. *Portland Press Herald*, May 24, 2000 (as reprinted from *The Washington Post*). Would any traveler really

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[10] *See Housatonic Railroad Company, Inc. Comments*, at 3.

want to be forced to choose between only two airlines?

The rail industry duopolists already are instituting rate increases in the hope of lifting short-term earnings and reinflating depressed stock prices. Even in the partitioning of Conrail – justified in large part by the reinstitution of competition where there had been none – the successor companies are raising rates to assist in debt reduction as they struggle to establish market share. Because of the massive debt incurred in overpaying for Conrail's assets, both acquiring carriers essentially are asking shippers to help finance their transactions, exactly the opposite of what was represented. In the process, they risk driving away the very truck-sensitive traffic that both proclaim is essential to the ultimate success of their acquisitions. This is a flawed short-term strategy, for customers will not pay for inferior service.

One of the two members of Congress to submit comments succinctly summarizes the current industry condition: "Where the nation faces a duopoly, the needs and desires of private management must be placed squarely second to the nation's goal of providing the entire nation with efficient service at fair prices." *U.S. Representative Jerrold Nadler Comments*, at 7. If the duopolists will not forthrightly address issues raised on behalf of both shippers and feeder carriers (many of which have not commented in this proceeding for fear of Class I reprisal), then it is up to the Board to do so. The attached cartoon concerning airline predation unfortunately is not unlike the relations between some short lines and their supposed Class I "partners."

The "private-sector solutions" to merger concerns encouraged by the Board and favored by politicians are not realistic for most short lines. Applicants typically make back-room deals with parties having some influence, but ignore those that do not. *See Ohio Rail Development Commission Comments*, at 7. The concept of market extension negotiated by

Wisconsin Central Ltd. with prospective applicants The Burlington Northern and Santa Fe Railway Company and Canadian National Railway Company, for example, should be afforded to other small carriers connecting with those Class Is, and all private agreements made in connection with the merger proceeding should be fully discussed in the public interest. *See KCS Comments*, at 44-54.

FMRS's observation that grain issues have an important bearing on the business conduct of the Western Class I railroads is confirmed by other respondents. It is clear that prejudicial service and pricing schemes exist with respect to captive shippers versus those with rail options (*see Kansas Department of Transportation et al. Comments*, at 15), anti-competitive cross-border differentials (*see North Dakota Public Service Commission et al. Comments*, at 8), demarketing of short-line carload traffic in favor of main-line stations (*see Montana Rail Link, Inc. et al. Comments*, at 5), and devaluation of public-sector investment made to preserve rail access (*see Chillicothe-Brunswick Rail Authority et al. Comments*, at 1; and *Oklahoma Department of Transportation Comments*, at 5). While the premise that grains are differentially priced commodities is generally accepted, it is equally clear that the public-interest burden of differential pricing is not being fairly distributed. All of these phenomena are facilitated by the absence of effective competition and would be checked by the presence of meaningful competition.

The thrust of FMRS's comments is that the 500-plus short lines should be used as a means of extending rail competition more broadly throughout the country. This concept is well articulated by the Port of Seattle et al. in its contention that "A shortline can be viewed as a small shared assets area." *Port of Seattle et al.*, at 8. "A competitive rail market requires that shippers have access to at least two rail carriers. This means that there must be in place a practical and economic method by which they can 'call another railroad' if they become dissatisfied with the price and service of the railroad with which they are dealing, even if the lines of only one railroad reach the shipper." *Id.*, at 5. Such an approach would place shippers and communities outside the railroad "mainstream" on a sounder footing in relation to competitors that presently are more advantageously located to benefit from the latitude afforded the major railroads by the Staggers Act.

It is time to be more concerned about 1-to-2 than about 3-to-2. Two may be enough, but it is not available in enough places. *See Iowa Traction Railroad Company Comments*, at 2; and *McKinley Paper Company Comments*, at 1. FMRS also "questions whether additional Class I consolidations will ever be in the public interest." *Union Pacific Railroad Company Comments*, at 2. "The Board needs to act both within and outside of its 'merger rules' to provide for a truly competitive rail marketplace." *National Industrial Traffic League Comments*, at 20. That initiative should include not only the removal of anti-competitive paper barriers, but also steps to extend competition by taking advantage of the shorter-haul marketing orientation of the small railroads. *Id. See also Wisconsin Central Ltd. et al. Comments*, at 10.

Summary of Recommendations

Based on its own views and those reflected in the comments of others, FMRS believes that the Board should amend its guidelines to reflect the following principles:

1. There is no need for end-to-end merger to accomplish the goal of an efficient North American rail transportation system. The principal benefits of consolidation can

be achieved short of merger. Future mergers should only be permitted where it is clear that there are public benefits that cannot otherwise be achieved.

2. The East-West duopoly should be maintained and at least minimal competition should be extended over a broader geographic scope. Too much of the domestic market lacks sufficient rail-to-rail alternatives.

3. The current "Big Four" must demonstrate an ability to manage existing operations to the general satisfaction of the shipper community. Current service reliability should be a precondition to any further mergers.

4. Attention must be refocused from maximizing length of haul to using an improved cost structure to capture truck-sensitive traffic. Elimination of capacity constraints will stimulate untapped intra-regional growth.

5. Short lines can be the vehicle for broadening competition to the fringe of the network. This role requires greater equity in service, pricing and car supply.

6. The Board should establish a workable mechanism for shippers and railroads to redress fairness issues arising from market dominance. The alternative is reregulation or pursuit of antitrust remedies.

Specific Recommendations

FMRS set forth specific recommendations in its Comments (*FMRS Comments* at 28-29)[11] that were directed primarily towards the role and protection of short lines in future merger proceedings. FMRS believes that its recommendations are supported by the comments

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[11] For convenience, a copy of the proposed regulations is attached as Appendix A.

made by a number of shippers and other parties, and are consistent with the specific regulations proposed by some of those parties. *See ASLRRA Comments* at 6-8; *Montana Rail Link et al. Comments,* at 6; *KCS Comments*, at 84; *Coal Shippers Comments*, at 22-23; and *Port of Seattle, et al. Comments*, at 12-13.

FMRS also specifically supports the calls for damages for merger related service problems, and the institution of a mechanism for the prompt resolution of claims for such damages. These requests have largely been made for, or on behalf of shippers. However, short lines that also suffer when either traffic cannot be delivered to or taken from the shippers they serve, suffer as well. *See FMRS Comments*, at 29; and *ASLRRA Comments*, at 7.

Conclusion

For the foregoing reasons and the reasons set forth in its Comments, FMRS requests that the Board modify its major merger procedures consistent with the regulations proposed by FMRS.

Respectfully,

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Dated: June 2, 2000

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VERIFICATION

I, George C. Betke, Jr., CEO of Farmrail System, Inc. verify under penalty of perjury that the foregoing Reply is true and correct. Further, I certify that I am qualified and authorized to file the foregoing Reply.

Executed on June 2, 2000.

George C. Betke, Jr.

APPENDIX A

Recommendations

Based on the foregoing discussion, FMRS recommends the following changes to the Board's major rail consolidation procedures that are currently set forth at 49 C.F.R. §§ 1180.0-1180.9.

(1) Add to §1180.1(c) *Public interest considerations:*

In determining whether a transaction is in the public interest, the Board shall find the following:

(a) Short lines provide an operational and administrative means of aggregating small shippers, and in general, short lines should be treated as shippers and not as competitors of the applicants.

(2) Add a new subsection:

The Board has determined that certain classes of conditions should be imposed in all major rail consolidations because the public benefits from such conditions outweigh any lessening of the benefits to the applicants or the public. These conditions are:

(a) Applicants shall agree to terminate immediately all competitive blocks as they relate to new traffic (traffic not currently moving by rail) and those that are more than seven years old, and to terminate all other competitive blocks on their seventh anniversary.

(b) Applicants shall grant all short-line (Class II and Class III) carriers haulage or trackage rights, at commercially reasonable rates, to the nearest interchange with another Class I carrier, not to exceed 100 miles and without application of any competitive blocks.

(c) Applicants shall permit two short lines to make rates with each other if their junctions with the applicants are between Class I terminals or otherwise within 300 miles. Applicants shall handle the intermediate switch by haulage, or grant trackage rights, at commercially reasonable rates.

(d) Applicants shall allow connecting short lines to make rates for new interline business from origins or to destinations within 300 rail miles of the short-line interchange. Applicants shall provide commercially reasonable revenue requirements on a freight-all-kinds basis for this purpose.

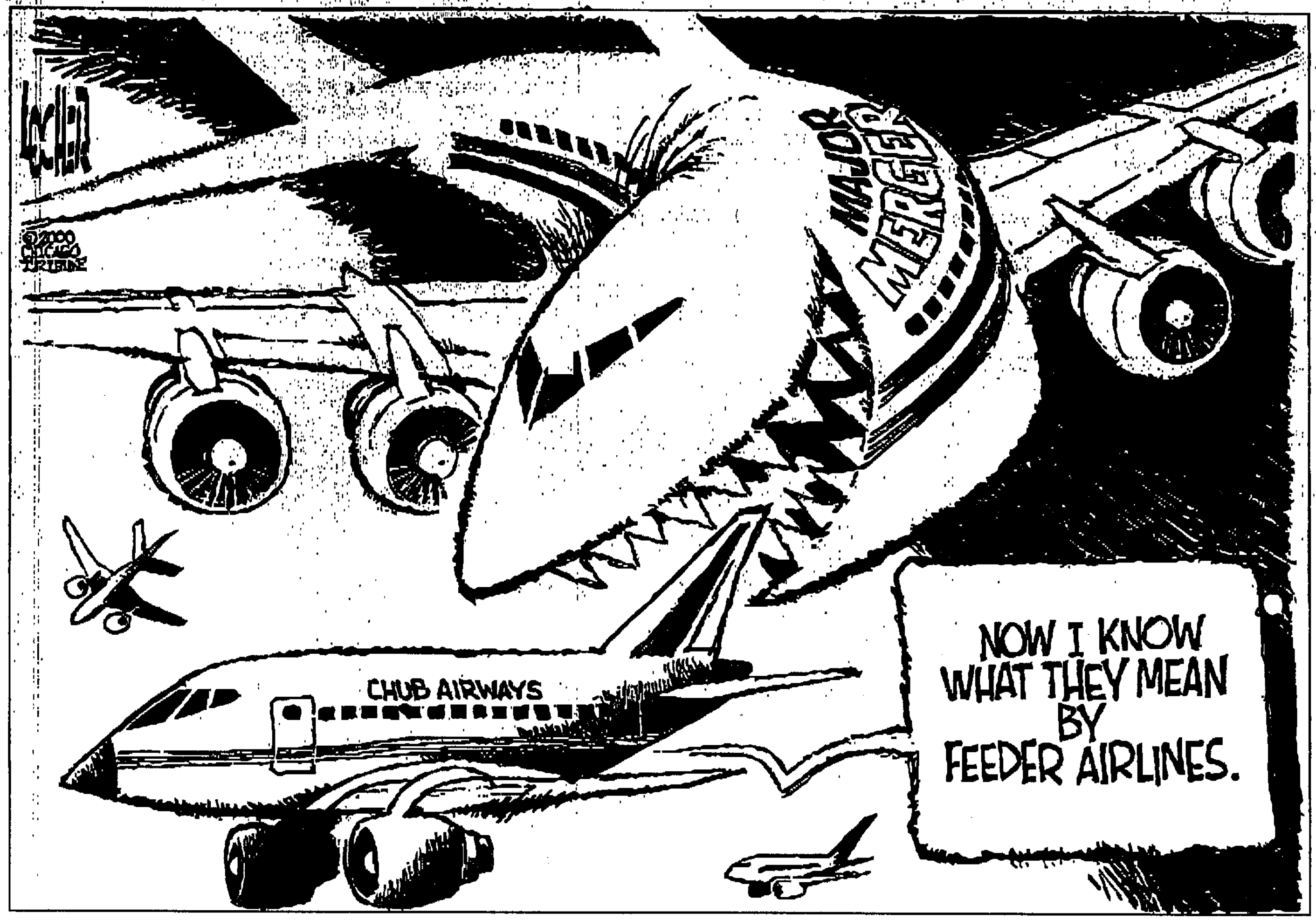
(e) Applicants shall not exercise any ratemaking authority to publish tariffs that effectively deprive shippers of service benefits offered by connecting short lines, including multiple switches and co-loading.

(f) In exercising any ratemaking authority, Applicants shall establish rates at short-line points consistent with their rate scheme for stations in the same gathering area for the same commodity.

(g) Applicants shall reimburse short lines for demonstrable damages, such as lost revenues and increased car hire, that result from service failures as measured by the service levels set forth in the application or under any private interchange service agreements between the parties.

(3) Add a new subsection establishing an expeditious appeal process for determination of alleged violations of merger conditions.

DICK LOCHER'S VIEW



CERTIFICATE OF SERVICE

I hereby certify that on this date a copy of the foregoing Reply of Farmrail System, Inc. was served by First Class Mail, Postage Prepaid, on all Parties of Record.

Dated: June 2, 2000

ERIC M. HOCKY